Economic Outlook

Euro Zone, US and Emerging Markets

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Recovery with obstacles

EU countries impress with good crisis management
Although the pandemic is not yet under control world-wide, quarantine measures have been relaxed in almost all regions of the world. This has enabled a gradual economic recovery from May onward. In Europe and China the prospects for a continuation of this recovery are good, as the number of COVID-19 infections is currently under control there. By contrast, in the US the number of new infections has recently increased again, hence the outlook is subject to greater risk. As long as there is no medical solution for COVID-19, uncertainty regarding the economic outlook remains high. The quality of crisis management and compliance with safety measures will determine how the recovery in different economic regions evolves.

Euro zone economy – member countries affected to different degrees
The Netherlands and Germany have so far come through the corona crisis with little economic damage, while France, Italy and Spain are facing a significant economic slump. For 2020 as a whole, we expect euro zone GDP to contract by 7.1%, followed by a recovery in 2021 (+5.4%). This forecast is based on the assumption that future infection outbreaks can be held in check regionally and economies will therefore no longer have to be brought to a complete standstill. Initial economic data for May already point to a noticeable recovery.

Euro zone inflation – weighed down by oil prices
In 2020, we are forecasting a deceleration in the euro zone headline inflation rate to +0.4% due to the slump in oil prices. Oil prices remain the decisive driver of short-term fluctuations in euro zone headline inflation. As a result of the crisis-induced adverse trend reversal, the labor market is putting pressure on the longer-term inflation outlook for the euro zone. The ECB has therefore adopted a considerably more expansionary monetary policy stance; nevertheless, it expects the inflation rate to remain muted and reach a mere 1.3% by 2022.

US - high infection rates an uncertainty factor
The US economy shows clear signs of a recovery after the massive slump in April. However, following the recent sharp rise in the number of daily new COVID-19 infections, risks to the economic outlook have increased. We currently assume that the containment measures will turn out to be sufficient and that nothing will hamper a continued recovery. For the year 2020 as a whole, we expect a 5.5% contraction in GDP. The weak economy will generally dampen domestic price pressures. Oil prices should be the only driver causing noteworthy fluctuations in the inflation rate.

Content

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Global Economy

Severe recession in 2020

All regions of the world affected

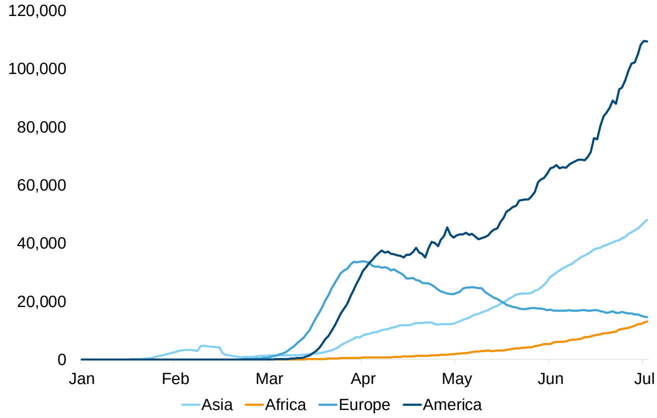
Shortly after tentative signs of a global economic recovery had emerged in early 2020, the COVID-19 pandemic triggered the most severe recession in 70 years. The IMF expects that the global economy will contract by 4.9% in 2020. In light of the intense outbreaks in countries such as Brazil, India or Russia, the IMF for the first time forecasts a significant economic slump in emerging markets as well. However, despite pronounced regional differences in the number of new infections, almost all regions of the world have begun to gradually reopen their economies since the beginning of May. As a result of this, an economic recovery has taken hold in May in most large economic areas.

Governments, central banks, IMF and World Bank provide support

The governments and central banks of the largest economic areas (US, EU, China and Japan) have responded with comprehensive fiscal and monetary policy measures in order to mitigate the economic downturn. Supra-national organizations such as the IMF and the World Bank have made additional funds available to stabilize smaller economies with a low level of prosperity. The Kiel Institute for the World Economy expects that international financial aid will reach new record highs due to the corona crisis. Global economic capacity utilization will nevertheless remain subdued for an extended time period. We therefore believe that unemployment rates in many economic areas are poised to remain at elevated levels for a lengthy period of time as well. We expect the number of long-term unemployed persons to increase particularly in the tourism sector as well as in the stationary retail sector.

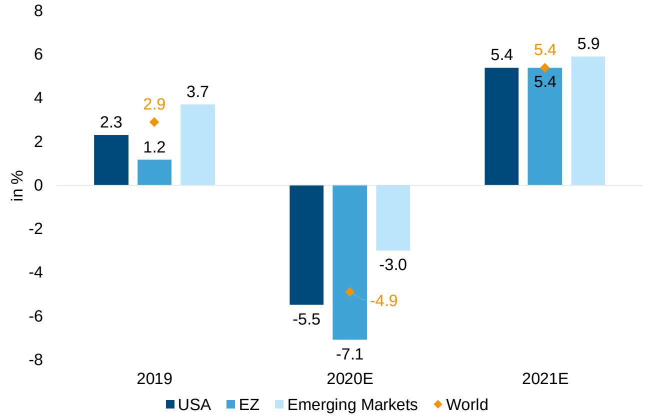
With the exception of Europe, the number of new infections is rising continuously on all continents. From a regional perspective the countries in Asia with the strongest rates of increase are currently India, Pakistan and Iran. In the Americas the standouts are the US, Mexico and Brazil. Given this backdrop, early reopening of the economy harbors risks in a number of countries and there is a danger that restrictions that were already lifted will have to be partly re-imposed. This would threaten the recent economic recovery.

Only Europe exhibits a downtrend
Daily new Covid-19 infections (7-day avg.)



Source: Eurostat, Erste Group Research

Severe economic slump in 2020
GDP growth 2019 – 2021E



Source: IMF, Erste Group Research

Euro Zone Economic Outlook

Large differences between countries in terms of economic impact

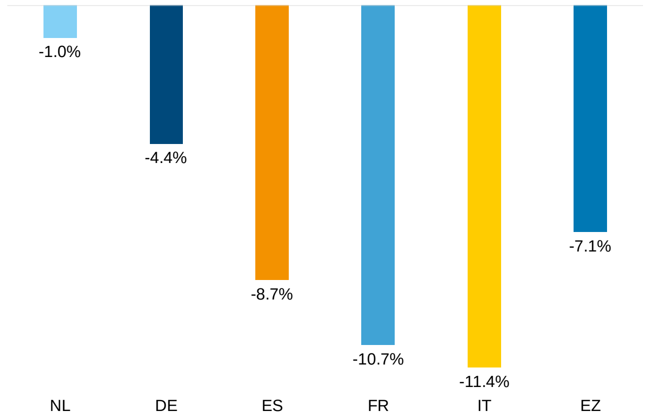
COVID-19 under control

The necessary quarantine measures to contain the spread of the corona virus have been successful in the EU and infection rates are steadily declining since early April. Unfortunately the restrictions imposed in almost all countries in the first half of 2020 have triggered the most severe economic slump in more than 70 years. Interestingly, there were noticeable differences in terms of economic damage on the country level. The Netherlands, Germany and Scandinavia in particular have so far weathered the crisis comparatively well. This is probably primarily attributable to the proactive use of less stringent restriction measures in combination with greater trust in the willingness of citizens to exercise personal responsibility. Moreover, the superior ability of these countries to cope with the challenges of the crisis is likely also due to their higher degree of digitalization. Scandinavia and the Netherlands are highly ranked in the EU Digital Economy and Society Index, while France and Italy have considerable catching up to do.

Leading indicators improving since May

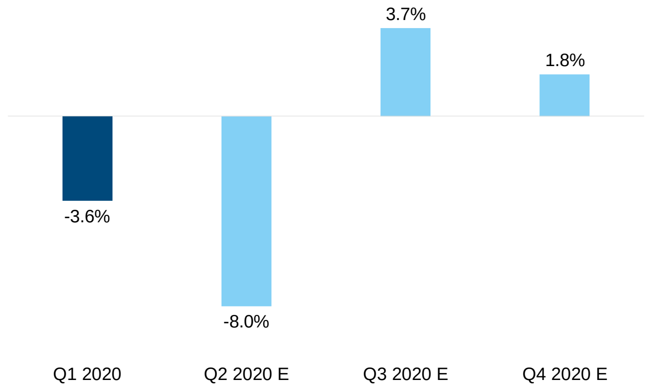
As a result of this, economic imbalances within the euro zone are poised to increase after the crisis. Given this backdrop we believe that the reconstruction fund of the EU Commission ("Next Generation EU") will play a crucial role in stabilizing the currency union economically and politically. For 2020 as a whole we expect a steep decline in euro zone GDP by 7.1% followed by a recovery in 2021 (+5.4%). This forecast is based on the assumption that future infection outbreaks can be held in check regionally and it will no longer be necessary to bring entire economies to a complete standstill. In the short term leading indicators are gradually improving as restrictions are eased. For instance, truck traffic on German roads (as measured by the truck toll index) is rapidly increasing since early May. In view of the central role played by German industry as a hub for all of Europe this is an encouraging signal for the entire euro zone economy.

FR and IT hit the hardest so far
Estimated GDP contraction: Jan-May 2020 (y/y)



Source: Eurostat, Erste Group Research

Downturn should bottom out in 2Q
EZ GDP growth 1Q-4Q (vs. previous quarter in %)



Source: Eurostat, Erste Group Research

Euro Zone Potential Growth

Long-lasting under-utilization of economic resources to be expected

Economy out of balance

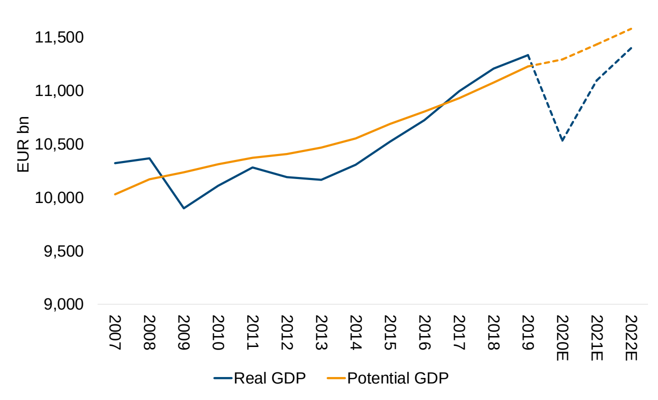
Since the financial system and euro crisis of the years 2009 to 2012, euro zone member countries are making an effort to keep the momentum of economic growth and economic resources in equilibrium. The pace of economic growth that keeps resource utilization in balance is referred to as the potential growth rate. The degree of capacity utilization of an economy (the difference between potential GDP and real GDP) is measured in terms of the "output gap". It is negative in the event of capacity under-utilization and positive in the event of capacity over-utilization.

The shock of the financial system and euro crisis led to a long-lasting period of capacity under-utilization in the euro zone economy. The negative output gap could not be closed before 2018. Spain and Italy in particular needed time to reduce macro-economic imbalances (inter alia large current account deficits prior to 2009). If an economy does not operate at its potential growth rate for an extended time period, there is a risk that the momentum of economic growth could be impaired in the long term; e.g. due to the fact that young people that are unemployed for a lengthy period of time are unable to gain work experience. However, qualifications and work experience of the labor force are important criteria in deciding on a business location.

Stimulus indispensable for safeguarding growth

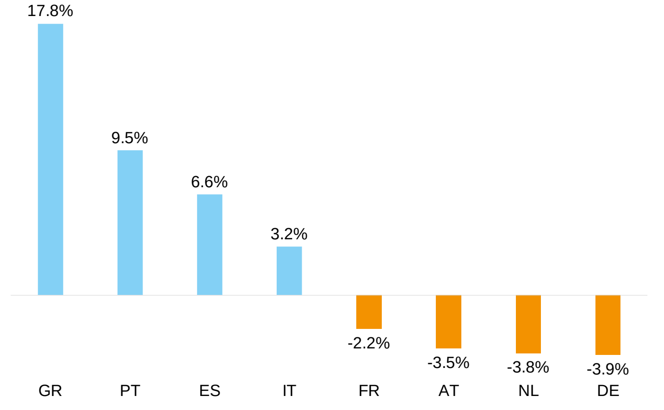
Due to the corona crisis we expect substantial under-utilization of economic resources over an extended time period. In view of this backdrop, resolute use of public funds is essential in order to mitigate long-term economic damage, even if it increases public indebtedness in the short term. The EU reconstruction fund ("Next Generation EU"), which is designed to promote the development of structurally weak regions, should provide a significant contribution in this context. Its aim is to secure the political and economic stability of the EU and the euro zone. On the country level, primarily Greece, Portugal and Spain stand to benefit as recipients of the planned grants. The positive impact on Italy's economy will be less pronounced due to the country's relative size.

Severe slump in 2020
EZ real GDP vs. potential GDP (2007 – 2022E)



Source: Eurostat, Erste Group Research

Southern Europe the main beneficiary
Net flow of funds, EU reconstruction fund (% of GDP)



Source: European Commission, Erste Group Research

Euro Zone Inflation

Adverse trend reversal in labor market weighs on inflation outlook

Oil price triggers volatility

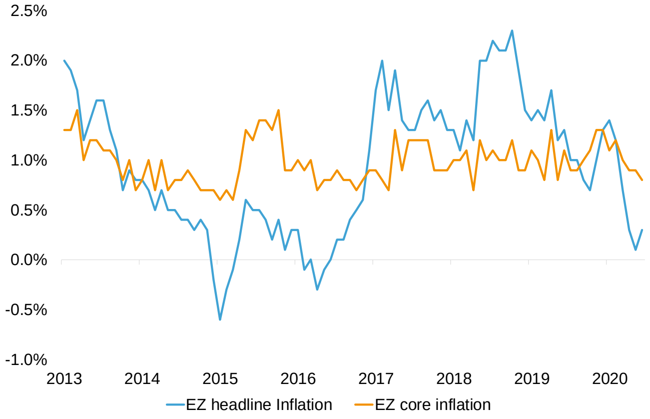
We are forecasting a deceleration in the euro zone headline inflation rate to +0.4% in 2020 due to the slump in oil prices. In 2021 we expect a recovery to +1.2%. In the short term, global oil prices remain the decisive driver of changes in the pace of headline inflation in the euro zone. By way of illustration, declining crude oil prices led to a significant decrease in the headline inflation rate in the first half of the year, to a level close to 0%. However, as oil prices are gradually recovering since April, we expect downward pressure on headline inflation from this source to ease in the second half.

In the longer term, the degree of capacity utilization of the labor market - through its influence on wage growth - is decisive for the inflation outlook (core inflation in particular). Since its last major peak at 12.1% in early 2013, the unemployment rate in the euro zone had declined to a level of 7.1% by the beginning of 2020. However, the European Commission expects the Corona crisis to cause a material increase in the euro zone unemployment rate to 9.6% by the end of 2020. Various short-time work programs will prevent an even more significant increase. This under-utilization of the labor market is bound to exert a dampening effect on core inflation in the euro zone for the foreseeable future. Moreover, the high level of uncertainty triggered by the pandemic weighs on consumer spending, which has an additional dampening effect on inflation.

ECB expands measures

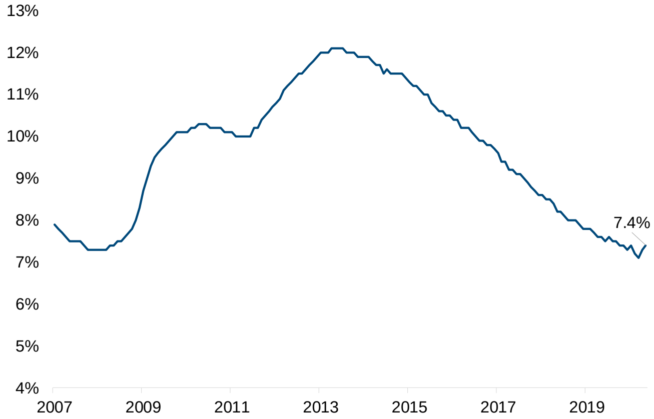
Against this background, the ECB has expanded its monetary policy measures (inter alia securities purchases) substantially in the first half of the year. Despite its efforts the ECB expects that euro zone headline inflation will reach just 1.3% by 2022, which would still be well below its price stability target (an inflation rate below, but close to 2%).

Core inflation stable since 2017
EZ headline inflation vs. core inflation (2013 – 2020)



Source: Eurostat, Erste Group Research

Increasing since April 2020
EZ unemployment rate (2007 – 2020)



Source: Eurostat, Erste Group Research

Germany

Early preventive measures minimize economic slump

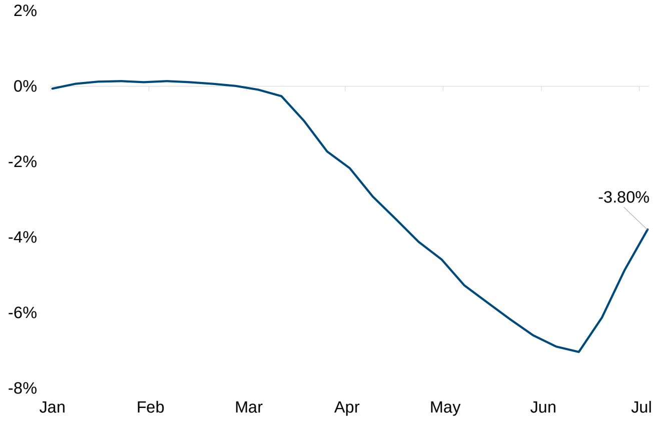
GDP (Jan – May): -4.4%, y/y

Germany has weathered the corona crisis comparatively well. In our assessment, early and measured restrictions were decisive in this context; they made it possible to keep the economic damage to a minimum. We estimate that Germany's economy contracted by 4.4% between January and May compared to the same period of the previous year. The weekly activity index for the German economy indicates that the trough was reached at the beginning of June.

For 2020 as a whole we expect a GDP contraction of 6.1%, followed by a recovery of 5.1% in 2021. Due to healthy public finances, Germany is able to extend generous support to its economy. The federal government has agreed on implementing an economic stimulus package in the amount of EUR 130bn (equivalent to around 4% of GDP). The package includes a reduction in VAT rates until the end of the year, grants for families, and investments in future-oriented economic activities (inter alia hydrogen, artificial intelligence). This package makes an important contribution to cushioning the impact of the crisis while at the same time safeguarding Germany's growth prospects.

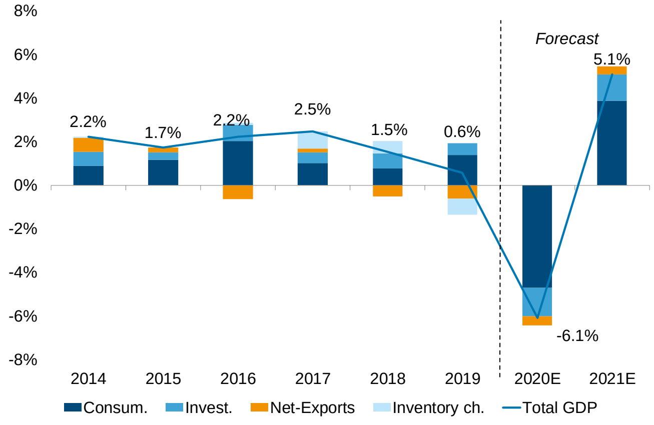
Since not all countries have generous financial resources comparable to those of Germany at their disposal, we expect the gap (inter alia in terms of public debt, GDP per capita) between Germany and other large euro zone member countries such as France, Italy or Spain to widen. Alas, this is not desirable for the economic and political stability of the euro zone. It is therefore important that Germany lend its support to the EU reconstruction fund, so as to keep prosperity levels from drifting apart too much.

Economic activity gathers pace again
Weekly activity index of the German economy



Source: German Bundesbank, Erste Group Research

Rapid recovery expected
DE - GDP growth by components



Source: Eurostat, Erste Group Research

France

Belated response precipitates deep recession

GDP (Jan – May): -10.7%, y/y

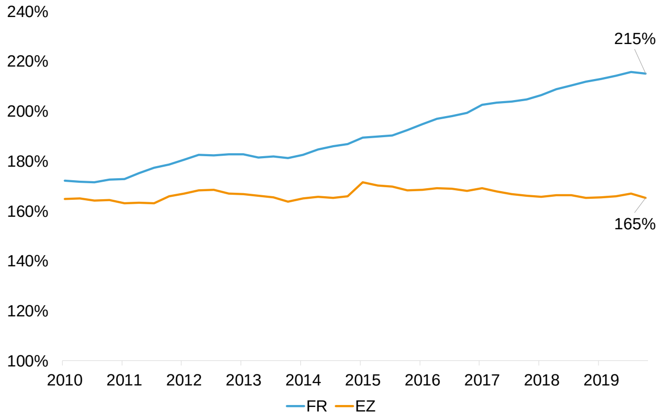
France responded comparatively late to the COVID-19 outbreak. As a result, the country's health care system was severely overburdened. In light of this backdrop, the French government was forced to maintain drastic restrictions for a long period of time. It was not until the beginning of June that a gradual easing was implemented. We estimate that from January to May, the French economy contracted 10.7% year-on-year.

For 2020 as a whole, we expect France's GDP to contract by 8.4%, followed by a recovery in 2021 (+ 5.8%). In June the French government boosted a comprehensive stimulus package to support the economy to EUR 135bn. It is intended to provide funding for large corporations (e.g. Air France), small and medium-sized enterprises, as well as short-time work programs.

High debt-to-GDP ratio problematic

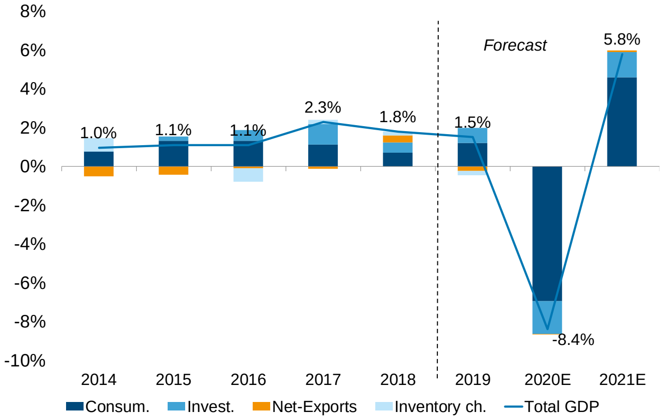
According to estimates of the European Commission, France's public debt will rise to a historic high of 116.5% of GDP by the end of 2020. As the recovery progresses, this metric should decrease to a level of roughly 110% over the medium term. France will have to demonstrate to the capital markets that there is a credible path toward a steady reduction in the public debt-to-GDP ratio. This constrains the country's fiscal policy leeway considerably. In addition to this, we consider the relatively high levels of French household and corporate debt (215% of GDP at the end of 2019) to be problematic. As a result, the private sector lacks the financial room to maneuver required to independently invest in the future after the crisis has passed.

Significantly above the euro zone average
Private sector debt in % of GDP (2010 – 2019)



Source: BIS, Erste Group Research

8.4% slump in output expected in 2020
FR - GDP growth by components



Source: Eurostat, Erste Group Research

Italy

High public debt-to-GDP ratio restricts room to maneuver

GDP (Jan – May): -11.4%, y/y

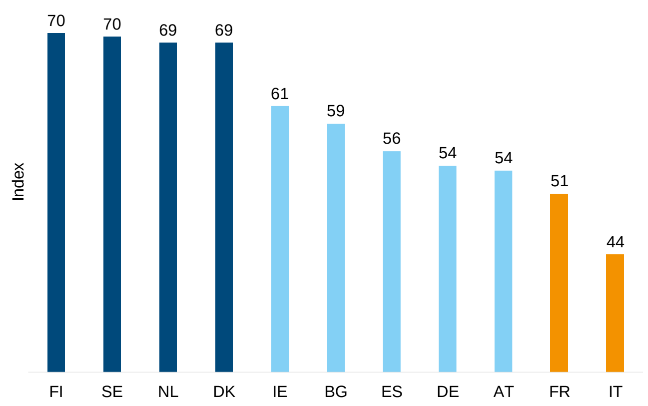
Italy was comparatively late in reacting to the outbreak of the infection. As a result, the government had to impose strict containment measures for a lengthy period of time. We estimate that the Italian economy contracted 11.4% year-on-year in the period from January to May.

For 2020 as a whole, we expect a GDP contraction of 9.9%, followed by a recovery of 6.0% in 2021. By means of a "Decreto Rilancio" (relaunch decree)[1], Italy's government has announced relief measures for the economy totaling approximately EUR 155bn, such as direct business grants, loan guarantees and tax deferrals. Italy's room for maneuver is limited due to a high public debt-to-GDP ratio. However, investment would actually be urgently needed in Italy, especially in future-oriented areas such as digitalization, as the EU Digital Economy and Society Index shows. Consequently, the EU reconstruction fund plays a crucial role in shaping the outlook for Italy's economy.

Rating in critical territory

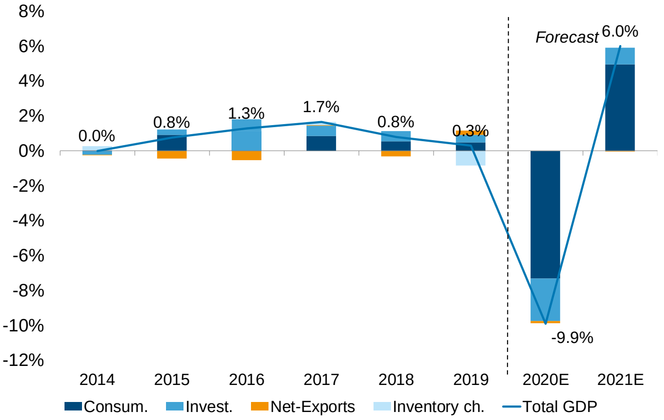
The European Commission estimates that Italy's public debt-to-GDP ratio will rise significantly to 159% by the end of 2020. The crisis measures adopted by the ECB (above all the "PEPP" program) are currently keeping financial markets calm. Nevertheless, capital market participants will closely monitor Italy to see whether a credible fiscal consolidation effort can be adhered to after the crisis. Thus future governments will no longer have any fiscal leeway whatsoever. Moodys and Fitch rate Italian government bonds just one notch above speculative grade, while S&P still rates them two notches above.

IT and FR with considerable shortcomings
EU Digital Economy Index



Source: Eurostat, Erste Group Research

9.9% slump in GDP expected
IT - GDP growth by components



Source: Eurostat, Erste Group Research

[1] http://www.mef.gov.it/en/inevidenza/Relaunch-Decree-155-billion-for-Phase-two-of-the-Economy-00001/

Spain

High share of tourism a risk factor

GDP (Jan – May): - 8.7%, y/y

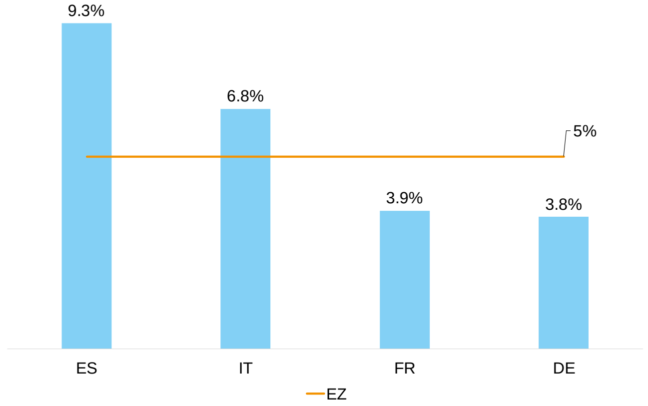
The economy of Spain will suffer an above-average slump in 2020 as a result of comprehensive, long-lasting containment measures. We estimate that the Spanish economy is likely to have contracted 8.7% year-on-year between January and May. We are forecasting Spain's economic growth to plummet by 8.7% in 2020, followed by a recovery of 5.9% next year.

Crisis drives change

Spain has so far announced fiscal support in the amount of EUR 36bn, but this may well increase. It will probably take some time before unimpeded international travel is once again possible. In light of the great importance of tourism for the Spanish economy, Spain is therefore bound to recover more slowly from the crisis than other countries in the euro zone. Parts of Spain's economy will have to reorient themselves in order to enable a more rapid economic recovery. The crisis does actually offer opportunities. Online business in Spain grew by 50% at the height of the crisis. Small local businesses are benefiting from this as well; new technological opportunities are widely expected to revitalize rural areas and smaller cities in Spain. Real estate portals are already reporting an increase in demand for properties outside of the major metropolitan centers[2].

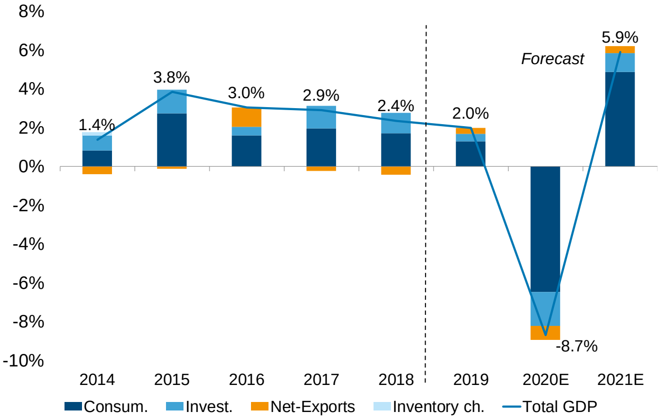
Since Spain's public debt is set to rise to historic highs by the end of 2020 (to around 116% of GDP), the government has little financial leeway for providing support to enable an economic transformation. Thus the EU reconstruction fund ("Next Generation EU") plays an important role for Spain's growth prospects, as the modernization of economic structures is one of the fund's key objectives. Relative to GDP, Spain is one of the main beneficiaries of the fund, along with Portugal and Greece.

High share in Spain
Employees, hotel and catering industries, in %



Source: Eurostat, Erste Group Research

8.7% slump in GDP expected
ES - GDP growth by components



Source: Eurostat, Erste Group Research

[2] https://elpais.com/economia/2020/06/18/nuevos_tiempos/1592475884_622672.html

US - Economic and Inflation Outlook

What will the recovery look like?

High rates of infection a significant uncertainty factor

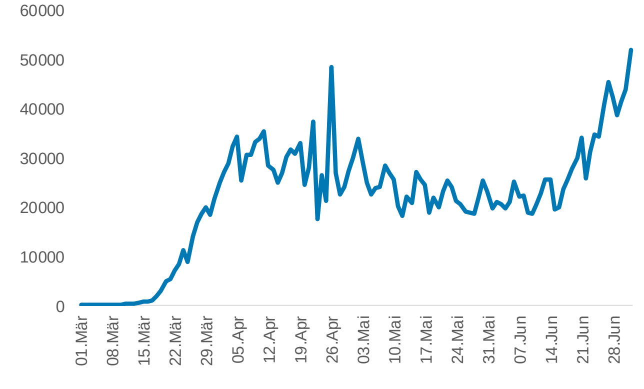
The significant increase in new infections with COVID-19 in numerous US states from the end of June onward has further increased uncertainty about the future outlook for the US economy. While economic data for May and June show a clear recovery after the slump in April, one should not attach too much importance to these figures. After all, it is clear that the initial easing of restrictions has the greatest impact. What is open question is not so much whether a recovery is coming, but how quickly it will proceed. We currently expect GDP to have slumped by about 10% in the second quarter and to recover less than half of that in the third quarter. Growth should then continue at a slower pace in the fourth quarter, but the previous losses will not be made up yet. However, given the rise in new infections, the downside risks to these forecasts have increased. This is due to the fact that rising infection rates are making renewed containment measures by the governments of the affected states unavoidable. It is hoped that measures that do not inflict too much damage on the economy will be sufficient, such making the wearing of masks mandatory. If this turns out to be unsuccessful, there would probably be no way of getting around the renewed imposition of tougher measures.

Economy should grow in the 3rd and 4th quarter – but how strongly?

Much is at stake for the US economy in any event. Although far from all states are affected by the resurgent outbreak, the three most populous ones (California, Texas and Florida) are among them. We do not believe that the US economy is likely to contract again in the third quarter, but the new outbreak certainly has the potential to set back the recovery markedly.

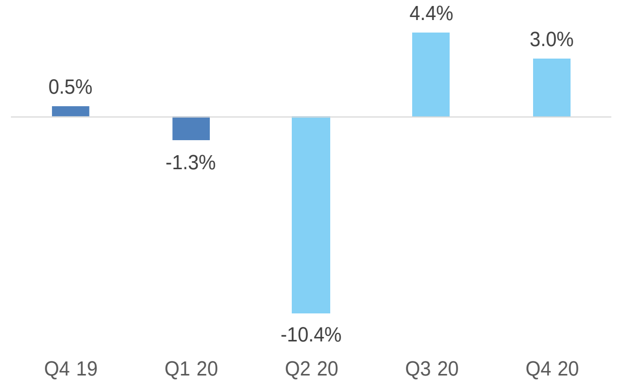
US headline inflation has probably already bottomed and we expect to see higher levels in coming months. The main reason for this is the rally in oil prices. By contrast, we expect the momentum of domestically generated price increases to slow down. Overall, inflation is poised to remain low by historical standards for the foreseeable future.

New infections rising sharply of late
Confirmed new daily COVID-19 infections



´Source: European Centre for Disease Prevention and Control, Erste Group Research

Uncertainty over recovery remains high
GDP, q/q in %



Source: Bureau of Economic Analysis, Erste Group Research

Emerging Markets

Fragile recovery comes into view

COVID-19 not under control

Uncertainty over the economic outlook for emerging markets is high, particularly with respect to countries with low levels of prosperity. New infections continue to increase unabated in large countries such as Brazil, India, Pakistan and Iran. However, due to limited testing capacities the data provide an inadequate picture of the actual situation. The number of undetected cases of infected persons is likely to be much higher.

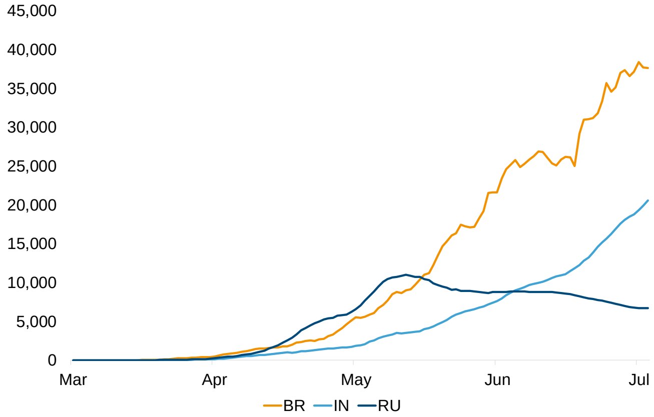
Countries dependent on financial assistance

Nevertheless, for a lack of alternatives many countries have already begun to gradually reopen their economies. As a result we expect COVID-19 infections to continue to spread in emerging markets for some time to come. Many countries depend on international aid in the face of this challenge; the IMF has e.g. provided financial aid in the amount of USD 64bn to emerging market countries since the outbreak of the crisis.

Expansionary Fed policy lends support

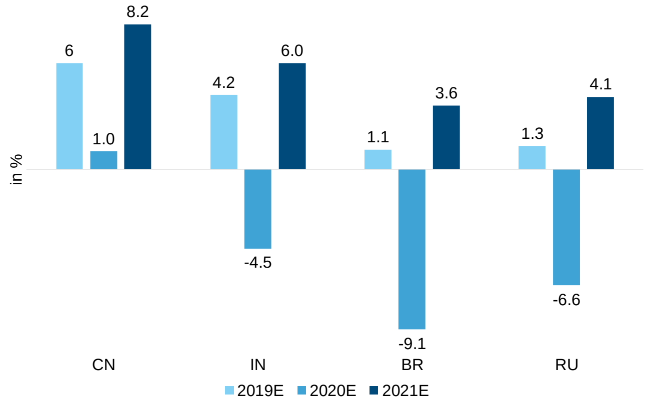
In the wake of the gradual opening of the global economy, leading indicators in emerging markets have improved as well. For example, commodity prices have been steadily recovering since April; a positive signal for countries that depend on income from commodity exports. Furthermore, emerging markets are benefiting from the recent rate cuts of the Federal Reserve through two different channels. For one thing, a considerable proportion of the funding requirements of corporations domiciled in emerging markets is covered by USD-denominated borrowings. Moreover, local central banks were able to cut their benchmark rates in sync with the loose policy adopted by the Fed. Through this channel, small and medium-sized enterprises as well as consumers in emerging markets are benefiting from declining financing costs. Since COVID-19 remains out of control in many emerging market countries, we believe the economic recovery could be subject to setbacks at any time.

Uptrend in Brazil and India
Daily new infections with COVID-19 (7-day avg.)



Source: Eurostat, Erste Group Research

Biggest slump expected in Brazil
GDP growth CN, IN, BR and RU 2019 – 2021E



Source: IMF, Erste Group Research

China

Recovery in full swing

COVID-19 under control

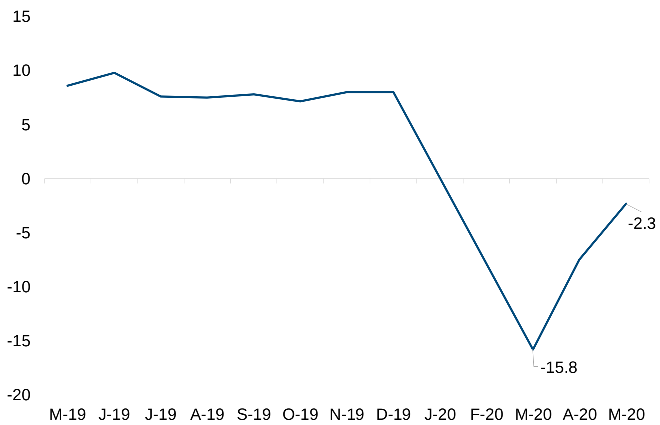
China is on the road to economic recovery since April. Since the peak of the crisis in February, only locally limited outbreaks have occurred. Recent events in Beijing have shown that authorities is capable of acting quickly and decisively. In addition, China can subject its citizens to by and large unrestricted electronic surveillance. We believe this is another factor arguing against a renewed uncontrolled outbreak of COVID-19 in China.

Stimulus shows effects

Just as the US and the EU, China has set extensive fiscal and monetary policy support measures for its economy into motion. China's fiscal stimulus amounts to around 4.1% of GDP, with an emphasis on improved unemployment benefits and tax relief. In addition, the People's Bank of China has provided extensive additional liquidity to the country's banking system (inter alia RMB 5.1trn through open market operations), has cut various interest rates and has implemented a staggered reduction in minimum reserve requirements. Thanks to these measures, credit growth in China has accelerated noticeably since March.

Leading economic indicators have regained their pre-crisis levels as of May. Retail sales have quickly recovered in this environment and as of May were just 2.3% below the level of last year. We expect the situation to continue to steadily improve in coming months. Euro zone exports should also benefit from this, as China is one of the largest trading partners of the euro area.

Rapid recovery
Retail sales y/y in %



Source: Statistics China, Erste Group Research

Favorable trend reversal in credit growth
Credit growth CN (y/y) vs. GER exports to China (y/y)

Source: Statistics Germany, PBoC, Erste Group Research

Forecasts[3]

BIP	2018	2019	2020	2021
Eurozone	1.9	1.2	-7.1	5.4
USA	2.9	2.3	-5.5	5.4

Inflation	2018	2019	2020	2021
Eurozone	1.7	1.2	0.4	1.2
USA	2.4	1.8	1.0	1.5

Source: Erste Group Research (own calculations)

[3] Note: In accordance with regulations, we are obliged to issue the following statement: Forecasts are not a reliable indicator of future performance.

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